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TAGS: ECON EFIN EAID MO
SUBJECT: GROWTH CONSTRAINTS -- APPLYING RODRIK'S MODEL TO
MOROCCO

Classified By: Economic Counselor Michael Koplovsky for Reasons 1.4 (b)
and (d)

¶1. (C) Summary and introduction: When judged against traditional "Washington Consensus" criteria (e.g. fiscal discipline, liberalization, privatization, and openness to investment) Morocco receives consistently high grades from international financial institutions and credit rating agencies. In its annual Article IV assessment, the IMF lauds Morocco for its macroeconomic stability and prudence. Yet dependable economic growth eludes the kingdom. Renowned Harvard Economist Dani Rodrik posits an alternative paradigm for explaining constraints to growth in developing countries. Using Rodrik,s criteria, Morocco's failure to spark sustained high level growth can be attributed to inadequate levels of private investment and entrepreneurship. Low levels of private investment, especially in the small and medium enterprises (SME) sector, may be due to scarcity of investible funds, exorbitant cost of capital, and/or insufficient social returns on capital (or the fact that investors cannot appropriate these returns.) While Moroccans pride themselves on centuries of experience as traders, entrepreneurialism (characterized by innovation and risk-taking) is not ingrained in the country's hierarchical and somewhat fatalist culture. Using Rodrik's model, the failure of investment to flow and of entrepreneurialism to flourish in Morocco, can be traced to two major factors 1) microeconomic risk rooted in poor property rights, corruption, and high taxation; and 2) low factor productivity arising from low levels of entrepreneurial rents, insufficient research and development, a lack of &self-discovery8) i.e. innovation. Two other factors -- rigid labor markets and poor human capital and too little bank competition leading to high interest rate spreads between deposits and loans) also characterize the Moroccan experience. End summary and introduction.

¶2. (U) Morocco has followed the Washington Consensus prescription for many years. As a result, for more than a decade, Morocco has achieved macroeconomic stability by most yardsticks. Inflation has remained in low single digits for several years, and below two percent for the last four. Although there is a visible trade deficit, thanks to remittances, tourism, and investment, Morocco's current account registers surpluses. Consistent Balance of Payments surpluses maintain high foreign reserves (currently equal to about one year's imports). Morocco's official debt to GDP

ratio stands at only 77 percent and continues to decline, its external debt is just 26 percent of GDP. While the economy is slowly diversifying away from its overdependence on the volatile agricultural sector, this sector, accounting for 40 percent of all employment and 15 percent of GDP, is directly dependent on unreliable rainfall. Morocco has signed free trade agreements with the United States and Turkey, and with Arab and Mediterranean partners. Under an EU Association Agreement, it has an evolving free trade relationship with its largest trading partner (over 80 percent of bilateral trade). Morocco boasts world class intellectual property rights protection and has made efforts to encourage and support foreign direct investment in key sectors. Liberalization of capital controls and exchange rates is underway, but at a slow pace. Privatization continues apace) the national telecommunications monopoly and the tobacco company have been sold, the shipping line is next on the block. Morocco has even pursued many "expanded" Washington Consensus criteria, including increased central bank independence, adherence to WTO rules and to international financial codes and standards (including Basel II), social safety nets, and poverty reduction programs.

¶3. (C) And yet, sustained, high levels of GDP growth elude the kingdom. In the past five years, Morocco's GDP has only had one year of six percent growth. Less volatile non-agricultural GDP growth figures are consistently below four percent. Morocco is unable to sustain economic growth levels sufficient to create enough jobs or to reduce poverty. World Bank economists estimate that sustained growth of at least six percent is needed to create jobs for the growing ranks of 18-25 year olds; currently about 180 thousand new workers per year enter the labor market. The expanding base of Morocco's population pyramid indicates this problem will

endure for at least another decade. Unemployment (officially around 11 percent, but up to double this level in urban areas and among young university graduates) remains a prime concern. Local economists, donor representatives and international development institution officials say that "corruption," inefficient and inept governance and structural obstacles are to blame. Moroccan government officials sometimes blame external shocks like high fuel prices (Morocco imports all its fossil fuel), investment flows, or terrorism's effect on tourism. Rodrik's paradigm offers a new way of explaining Morocco's predicament.

¶4. (C) Central to Rodrik's argument is his premise that the single most important symptom of low growth is inadequate levels of private investment and entrepreneurship. In countries where returns on investment and/or entrepreneurial activities are insufficient to attract economic activity (or are unable to be captured), economic development and reform programs, development aid, and investment promotion are doomed to fail at the goal of promoting economic growth. Rodrik notes that growth has been achieved absent reforms and countries that reform do not always grow. In Morocco's case, it can be argued that private investors are unable to appropriate the social and economic returns on their investments due mainly to high taxation (defined broadly to include not only government fees and duties, but also the inability to enforce contracts or property rights, institutional weaknesses, and corruption).

¶5. (C) High taxation, corruption, and weakly enforced property rights make up the microeconomic "private approbability" (i.e. the ability of firms to realize and internalize profits) problem in Morocco. With their highest marginal rate at around 40 percent, Moroccan personal income and corporate taxes are a brake on economic activity. A burdensome system of taxes and fees suffocates the minority of small businesses that do not choose the path of tax evasion. Widespread tax avoidance necessitates the maintenance of high rates for those who do pay. Low-level corruption is endemic to Morocco, but observers agree that petty bribes, nepotism, tax evasion, and informal networks do not add a burdensome cost to most significant investments or large-scale economic activities. They can and do, however

stifle entrepreneurialism and small investments. Expatriates, including NGO executives and Peace Corps Volunteers, report regular small bribes to traffic police and local municipal administrators, but large foreign investors rarely complain of corruption in large government procurement, investment policies, or treatment by the judicial system. Property rights systems, particularly for land titles, are opaque and unenforceable, according to many foreign operators. Only with the recent entry into force of the U.S.-Morocco bilateral FTA have intellectual property rights been strengthened to international standards. Enforcement remains weak. Anyone who walks through a Moroccan market will find pirated and counterfeit goods and widespread trademark infringement.

¶6. (C) Due to its risk-averse, fatalist culture and a top-down hierarchical system of governance (in both the private and public sectors), the level of entrepreneurialism in Morocco is low. Under past regimes, risk-taking and creative innovation could be punished severely. An education system inherited from the French encourages rote memorization of correct answers over creative problem solving and research skills. These factors combine to make Moroccans less innovative. While Moroccans welcome and regularly utilize new discoveries from abroad, one sees little indigenous research and development and hears of few new groundbreaking discoveries in Morocco. The entrepreneurial spirit is missing. Even if entrepreneurial culture existed, the economic policy deck is stacked against the returns to small and medium businesses, which reportedly account for 90 percent of enterprises and employ between three and four million Moroccans. High taxation, low level corruption, informal sector competition, and the disdain of the cosseted establishment conspire to undermine and de-motivate energetic entrepreneurs in Morocco.

¶7. (SBU) Two other less prominent, but problematic obstacles to private investment and entrepreneurship are poor

local finance due to insufficient competition in the banking sector and a rigid labor market characterized by poor human capital. The protected banking sector is sheltered and inefficient. It does not allow new entrants despite being unwilling or unable to offer many products and services available in developed countries. Unsecured small business loans or mortgages to relatively unknown clients are rare. Banks are able to invest deposited funds in government securities or in large, well-known corporations by keeping their interest rate spreads (loans versus deposits) at profitably comfortable levels, ranging from four up to nine percent. Moroccan workers are typically unskilled for modern technological work. The ranks of university graduates with a liberal arts background boast many prepared to take on managerial and bureaucratic positions, but include few engineers or scientists. Although it has recently improved, Morocco's European model labor laws include requirements (e.g. high severance costs, strict and costly health and safety requirements, and minimum wages) that make the labor market quite rigid, and deter small enterprises from hiring new employees. Morocco's labor rules especially deter growth beyond 10 employees (when employers must adhere to additional rules). Donor experts continuously point to this as a major growth constraint.

¶8. (SBU) Comment: The policy prescriptions of applying Rodrik's model to Morocco are clear. What is needed to create the proper climate for economic development, growth and job creation are more transparent and more rigorously enforced property rights, stronger anti-corruption measures (including efforts to absorb the large informal economy) and tax reduction and reform. Overcoming ingrained cultural obstacles to entrepreneurialism may be more difficult, but Moroccan officials and donor partners could help promote research and development and entrepreneurialism through training and exchanges (as the Middle East Partnership Initiative has already begun doing). The Moroccan government has already begun reforming its rigid labor regime and it recognizes the need to invest in 21st century educational

systems and methods to bolster its flagging stock of human capital. USAID, the World Bank, and other donors are funding modern vocational training and basic education programs to this end. Financial sector liberalization is underway. Two important sector reform laws have already been passed by parliament. The U.S.-Morocco FTA will, in theory, open banking and finance to international competition, expanding options for credit-seekers and squeezing commercial banks' margins.

¶9. (SBU) Comment (cont): However, observers should adopt these conclusions in the context of other measures of economic liberalization and reform. Just as Morocco's fulfillment of Washington consensus criteria was insufficient to ensure vigorous economic growth, addressing Morocco's shortcomings according to this analysis may not result in job creating growth and prosperity. This model provides only another way of diagnosing a frustratingly durable phenomenon of slow Moroccan growth.

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